

As recently as a decade ago they made up one of the most prosperous and attractive parts of the former Soviet Union, with a strong sense of national identity and rich cultural heritage. The post-Soviet period has been long enough for Armenia, Azerbaijan and Georgia to establish themselves as independent states deciding their fate. Each has gone a long way in building its own statehood.

But there is still something that unites them, but it is no longer positive. Widespread impoverishment, low living standards, rampant corruption, battered public infrastructures and mass emigration. Probably nowhere else has the collapse of Communism brought so much destruction and misery. That is the bitter truth about what was supposed to be a transition to democracy and market economy.

Despite more or less equal starting conditions, the countries of the South Caucasus have lagged far behind East European states and ex-Soviet Baltic republics that already feel benefits of the free market. The chasm between them will turn into an abyss if recent years' trends continue. The deeper the Armenian, Azerbaijani and Georgian peoples get stuck in their economic doldrums the more difficult it will be for them to find the path of development. Any further delay with solutions would cost the present and future generations dearly.

The past century was proof that, when allied to democracy and the rule of law, free enterprise always means a decent life for the vast majority of citizens. That is the essence of the "Western model" of society, the results of which are so visible.

All of the three Caucasian states have failed to embrace that model as the basis of their reform strategy. Citizens' right to change their government through elections has been severely restricted, if not denied, while government connections have been essential for engaging in entrepreneurial activity. Corruption and problems with the rule of law have stifled fair business competition, scaring off both domestic and foreign investors.

There is also another factor that dealt a devastating blow to the economies of the three neighbors. The conflicts in Nagorno-Karabakh, Abkhazia and South Ossetia rendered the region one of the most unstable and dangerous parts of the world. Even though the region has seen no large-scale hostilities for more than six years, its highly negative image lingers on.

Also in place are economic blockades, closed borders, ravaged infrastructures and, above all, uncertainty about the future. This reality goes against one of the main rules of the market economy: unfettered flow of goods and capital.

Common sense suggests that economic recovery is impossible without Armenia, Azerbaijan and Georgia opting for the Western model and making the region a safe place for business.

Democratization and other political reforms are vital for economic development, but their prospects are uncertain in all three countries. None of them can be considered a functioning democracy with free and fair elections and strong political parties. Therefore, political transformation is likely to take many more years.

Its success will be in question unless socioeconomic hardships are somehow alleviated in the near future. There seems to be no way that can happen if the uncertainty about peace and stability in the region persists.

Armenia, Azerbaijan and Georgia stand little chances of crawling out of the post-Soviet swamp without massive foreign investments. Even a distant look at their macroeconomic indicators suffices to bear out that assertion. They can now boast GDPs per capita hovering between \$600 and \$800 and official average salaries varying from \$35 to \$45. These are figures comparable to the level of development of many African countries.

A single-digit growth registered by the three struggling economies since the mid-1990s could not have had a major impact on living standards, with a sizable part of the population remaining out of work. Domestic consumer demand is too weak to generate a more robust growth, while the absence of advanced technologies hampers the development of local export-oriented industries.

The past decade has demonstrated that reforms have been a success in those ex-Communist nations that have attracted substantial foreign investment. The Caucasus has seen a far more modest influx of Western capital and has been paying a heavy price for that. Azerbaijan's oil sector may be an exception. But its impact on the rest of the Azerbaijani economy, especially its job-creating capacity, has proved to be quite limited. It appears that a number of things must be in place in order for foreign investors to take an interest in the war-ravaged region.

First is the existence of acceptable and stable "rules of the game". The Western model guarantees this through independent judiciary and a business-friendly institutional framework. The high level of corruption and nepotism in the countries of the South Caucasus is hardly encouraging for potential investors. There is no reason to expect this situation to change dramatically in the next few years. Even so, investors may come to the region in larger numbers if other, no less important conditions are met.

The threat of renewed fighting in Nagorno-Karabakh and other hot spots bodes ill for foreign investment. Little progress has been made in the search for a political settlement of the conflicts, and prospects for a lasting peace are uncertain. Potential investors are well aware of this reality.

One of the most far-reaching consequences of regional peace would be the re-opening of Armenia's borders with Azerbaijan and Turkey, which would pave the way for the movement of goods and capital across the region, something which is indispensable for economic growth in the era of globalization.

Open borders and weak trade barriers would be a huge step in the region's transformation into a sort of single market. A foreign company opening a factory say in Armenia would have its primary market increasing from 3.5 to 16 inhabitants. Renewed rail and road communication with Russia, Turkey and Iran would add to the market expansion. Settlement of the regional conflicts would thus allow the South Caucasus to cast off its negative image.

Leading Western powers already promise a hefty aid package for Armenia, Azerbaijan and Georgia as an additional incentive for conflict resolution. Much of the promised money (some reports speak of billions of dollars) would go to finance the reconstruction of their infrastructures and could serve as a catalyst of future foreign investments. Western firms taking part in the reconstruction work could thus get a foothold on local economies and think of longer-term commercial projects. Their presence could arouse a greater international business interest in the area, largely confined to Azerbaijani oil reserves at present.

In addition, a reopening of direct commerce between Armenia and Turkey and Azerbaijan would give a strong boost to economic activity throughout the region. For

one thing, Armenia would be able to restore railway connection not only with its two traditional foes but also with Iran, Russia and even Europe. For an economy suffocating from high transportation costs this would be quite a relief.

In sum, a re-birth of regionwide economic links, backed up by an influx of foreign aid and capital, is the sole remedy of enormous socioeconomic woes crippling the three Caucasian states.

The idea of regional integration, first floated by the West, seems to be increasingly popular among local elites, especially liberal technocrats. Several ways of putting it practice have already been suggested. All of them prioritize economic cooperation and call for a regional "security system". The most far-reaching and in-depth document yet was drafted this year by the Center for European Policy Studies (CEPS), a Brussels-based think-tank. At the heart of its "Stability Pact for the Caucasus" is the idea of the "South Caucasus Community" modeled after the European Union.

One may find unrealistic its call for supranational regional institutions, shared sovereignty, policy coordination and a free trade regime. The three countries, after all, are not as "European" as they portray themselves. Besides, Armenians and Azerbaijanis are too far from perceiving common interests.

And yet the idea should not be dismissed as infeasible just because it sounds so unbelievable to local pundits. One may question certain elements of the CEPS plan, but its core concept is definitely correct.

The creation of the South Caucasus Community may indeed be a long way off, but the process can already be set in motion. Again, a normalization of relations would alone give a powerful impetus to regional integration. As the Armenian, Azerbaijani and other peoples deepen direct contacts and see mutual benefits, conditions will become ripe for transforming the region into a single economic and possibly political space.

With its ambitious projects such as TRACECA and ideas like the Stability Pact, Europe gives Armenia, Azerbaijan and Georgia a chance to join the "civilized" world, to get their citizens out of misery and to live at peace. The alternative is continued poverty, exodus of the skilled workforce, corruption, threat of renewed wars and vulnerability to external manipulation. They must not fail to seize upon this opportunity.

The protracted economic slump has also blighted the institutions of civil society in all three nations, resulting in a sharp decline in educational standards and "pauperization" of a large part of the population. The de-industrialization and shrinkage of their economies adversely affects democratization. Impoverished, desperate and hopeless people are much easier manipulated by the corrupt elites. In Armenia, for example, citizens' readiness to accept vote bribes (unthinkable several years ago) spares ruling circles the need to falsify elections.

Quick economic recovery is therefore vital for the development of democracy in this part of the world. Rising living standards would inevitably increase pressure for popular participation in the political life. The existing situation is a fertile ground for populism and demagoguery that heightens public disillusionment with reforms.

Of all the obstacles to the realization of these ideas the Nagorno-Karabakh conflict is undoubtedly the most serious. Many other problems hampering integration would disappear once a solution is found to the decade-long dispute. Positions of the conflicting parties are still too different. A mutually acceptable peace deal can be achieved, however. Most realistic, it appears, is a Bosnia-type "unconventional"

formula that would place Karabakh and Azerbaijan under a loose state umbrella. The OSCE Minsk Group's most recent peace plan apparently goes along the same lines.

A settlement based on mutual compromise may be on the cards if the Russian, American and French co-chairs of the Group act in a more assertive way, which requires a more high-level diplomacy similar to one we have seen in the Middle East and the Balkans.

None of the parties would find it easy to sell a deal on Karabakh to the domestic public. In Azerbaijan, the mainstream opposition will not agree to anything more than a conventional autonomy status for Karabakh. Similarly, there will not be lack of opponents in Armenia of a possible arrangement that would give the enclave only de-facto independence. Still, the authorities in Yerevan and Baku are currently strong enough to withstand domestic opposition. But that may not last forever, considering the old age of Azerbaijani President Heydar Aliiev.

There is also a big question mark over Russia's true intentions with regard to the South Caucasus. The dominant view in the West, particularly in the United States, is that Moscow is not interested in peace because it fears losing its main leverage over the regional states. Things might not be so clear-cut on closer inspection though. If Russia is given a stake in the new regional order it could act as one of its main guarantors, especially when it comes to peace-keeping operations.

One of the merits of the CEPS's Stability Pact is that it seeks to bring the Russians into play. CEPS experts believe that Russian, EU and US interests in the Caucasus "are not necessarily divergent". The region is also "the terrain where a new chapter of, hopefully, constructive cooperation can be opened between Russia and the West", according to them.

Besides, Moscow's capacity to scuttle a Karabakh settlement will diminish if there is a genuine will to end the conflict from the Armenian and Azerbaijani sides. The ball is on their court. They should act before it becomes too late.